

**Specification:**

Replace the section entitled BACKGROUND OF INVENTION – OBJECTS AND ADVANTAGES with the following paragraphs:

The object of the invention is a method that enables companies and individuals to employ the financial leverage and theoretical characteristics of options without being bound by the limitations and imperfections of the traditional option market. Model options objectify the uncertainty associated with the pricing of options using an agreed value approach.

Model Options help expand the usefulness of options by enabling participants to easily understand the components of option valuation and to provide ready and continuous access to option pricing, even when there is no active options market. With Model Options, debates about marking-to-model and marking-to-market disappear.

In the case of ~~incentive stock~~ options used as compensation (where the contract is granted in exchange for work, intellectual property, expertise or some value other than money), companies and employees can make use of the financial leverage associated with options without having to worry about whether the option pricing model they use is accurate. With Model Options, the model accurately specifies the value of an option because it is the value of that option.

With Model Options, buyers and sellers no longer need to be wary of long-duration, or deep in-the-money or deep out-of-the-money options. They can confidently employ options to help them gain financial leverage because they can be confident that thin markets and poor liquidity will not distort prices.

Since price discovery is not necessary for Model Options, buyers and sellers can trade without the need for a traditional market such as an exchange. By alleviating the need for options to be traded on an exchange, option usage can be significantly expanded and trading costs can be reduced. This is especially true for deep out-of-the-money options where the expected value of such options may be less than the transaction fees. The current market-based approach to option pricing discourages trading of such options because the fees are static and

participants end up paying trading cost that are too large in relation to what the underlying options are worth to be economical.

Model Options enable options to be traded on small company stocks. Currently, options exchanges are not interested in such trading because it does not represent a significant amount of transaction volume, and the cost of such activity is not worth their trouble. Conversely, market participants generally steer away from such trading due to fears of pricing distortions and the potential for manipulation.

Model Options can be priced continuously, enabling interim settlements of value. This is a helpful means of reducing counter-party credit risk. For example, buyers and sellers could agree that they will make interim payments to one another for increases and decreases in the value of an option once that option has a positive intrinsic value.

Unlike traditional Options options, Model Options can be structured so that they do not allow the holder to force delivery of the underlying asset ~~never permit the holder to exercise the option.~~ Instead ~~of forcing the holder to pay the exercise price to receive the underlying asset,~~ the parties can structure a Model Option so that the holder can receive its value as determined by the valuation methodology that is embedded in the option contract at expiration. This reduces transaction costs and may be especially useful when the option holder has no interest in converting the option into the underlying.

Another useful feature of Model Options is that each of the component parts of option valuation is specifically identified. This characteristic makes it possible for option participants to trade each of the underlying components of an option separately. For example, option buyers and sellers could agree to trade just the volatility component of an option.

Model Options may be applied to any type of option regardless of whether the "underlying asset" is a financial asset ~~underlying is a financial asset,~~ a commodity, or an item or collection of real or personal property.

Further objects and advantages are to increase the use of options by making their values more understandable and more reliable and by making them more cost-effective to trade. Other objects and advantages will become apparent from a consideration of the ensuing description and drawings.

Replace the section entitled SUMMARY with the following paragraphs:

This method permits a buyer and seller to exchange the financial characteristics of an option by agreeing on the characteristics of that option and a methodology that will be used for valuing that option. In essence, a Model Option is an option contract that specifies a formula that will be used to determine its value.

Instead of relying on the market to generate the appropriate value for an option, Model Options specify how an option will be valued by describing a valuation calculation methodology and how each of the inputs to that calculation will be derived. In addition to describing an underlying asset, a strike price, an expiration date or term, and the type of exercise any exercise conditions that is allowed (American, European, etc.), Model Options specify a particular option pricing model (such as the Black and Scholes, the binomial, etc.) and how each of its inputs will be calculated (i.e., the risk-free rate of interest, the historical volatility of the underlying assets price, the dividend rate, etc.).

This “agreed value” approach to option valuation may be used to determine the initial price of the option, the value of an option at any point during the term of the contract, and the value at the expiration of the contract. Thus, Model Options can be used in conjunction with the present market-based model of option pricing in many different ways.

Under the heading, DETAILED DESCRIPTION—FIGS 1 –PREFERRED EMBODIMENT, replace the section entitled Conclusion, Ramifications, and Scope of Invention with the following paragraphs:

From the description above it should be clear that this method of constructing an option valuation satisfies many purposes that can not be accomplished ~~via traditional~~ by constructing options in the traditional way. Incorporating a specific valuation methodology into an option contract makes option valuation more understandable, more certain, and less costly. Model Options help expand option usage by permitting buyers and sellers to use options in ways that are currently impossible.

Model Options eliminate the need for the price discovery function of an exchange. This enables trading on small company stocks, on long-duration options, and on deep out- of- the-money options that is not possible presently due to a lack of liquidity, and concerns about the potential for pricing distortions and manipulation.

Model Options eliminate the importance of small speculators to the price discovery process. This, in turn, lessens the importance of the credit risk management function that large exchanges provide. Absent the need for a price discovery function and a credit risk management function, it is possible for smaller exchanges consisting of large credit-worthy participants to trade Model Options with much lower transaction costs.

Model Options permit the buyer and seller to agree that the contract will never be exercised in the traditional way by forcing ~~and that the buyer will never force~~ delivery of the underlying asset. This prevents unnecessary trading since the buyer can receive value without having to force delivery of the underlying asset ~~having to exercise the option~~ or make an offsetting trade to close out a given trading position.

By reducing transaction costs, it becomes feasible for large institutions to buy and sell deep out-of-the-money Model Options that have very small expected

values. Currently, such trading is infeasible because, at a certain point, the cost of trading exceeds the expected value of the options.

By using Model Options to compensate people (i.e., a compensation contract), ~~employees of a business for achieving specific operational or financial targets,~~ companies and employees can gain the benefits of financial leverage while gaining certainty over the expense and the value associated with these options.

By agreeing to a specific formula for determining an option's value, investors can use Model Options to create more precise hedges.

Using Model Options, investors can disaggregate each of the component values of an option's price and trade each of these values separately. This is impossible with traditional options.

Although the description above contains certain specifics, these should not be construed as limiting the scope of the invention but as merely providing illustrations of some of the presently preferred embodiments of this invention. This methodology can be applied in many ways to all types of options, on all types of assets and can be used on options that are traded on exchanges or between two parties directly. Thus the scope of the invention should be determined by the appended claims and the legal equivalents, rather than by any particular example described above.